Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-597

EPH H. HOOVER, JR. AND LUCINDA HOOVER,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent,

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

H. STENNIS LITTLE, JR.
JOHN B. OWENS, JR.
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v.

UNITED STATES OF AMERICA,
Respondent,

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the Order of the United States Court of Appeals for the Sixth Circuit entered on July 27, 1977.

CITATIONS TO ORDERS AND OPINIONS BELOW

The Jury verdict was in favor of the petitioners. However, the United States District Court for the Middle District of Tennessee, Honorable L. Clure Morton presiding, granted the respondent's motion for judgment notwithstanding the verdict. The District Court's opinion is unofficially reported at 37 A.F.T.R. 2nd 76-480.[1]

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[1] District Court's Findings of Fact and Conclusion of Law is printed as Appendix A hereto.

The Order of the Court of Appeals affirming the District Court's order granting the respondent's motion for judgment notwithstanding the verdict is printed in Appendix A and has not been officially reported at this time.

JURISDICTION

The Order of the Court of Appeals was entered on July 27, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

THE QUESTIONS PRESENTED

1. Did the lower courts misapply the principles of law established by this Court in *United States* v. *Generes*, 405 U.S. 93 (1972) so that their decisions are in direct conflict with the standards established by this Court in *Brady* v. *Southern Railroad*, 320 U.S. 476 (1943) for granting of judgment notwithstanding the verdict.

2. Did the lower courts including the Court of Appeals for the Sixth Circuit misapply the principles of law established by this Court in *United States* v. *Generes*, *supra*, so that their decisions are in direct conflict with the decision of the Court of Appeals for the Ninth Circuit in *Anderson* v. *United States*, 555 F.2d 236 (C.A. 9, 1977).

STATUTES INVOLVED

The statute involved is a Section of the Internal Revenue Code of 1954, as amended, which is codified as Title 26 of the United States Code. The Section relied upon by the Petitioners is as follows:

SEC. 166. BAD DEBTS.

(a) General Rule—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * *

(d) Nonbusiness Debts.—

(1) General Rule.—In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 9 months.

(2) Nonbusiness debt defined.—For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * *

STATEMENT

The petitioners brought suit against the government under 28 U.S.C. § 3146(a)(1) for refund of federal income taxes for the years 1963 through 1966. At the completion of trial, the District Court instructed the jury in accordance with the principles of law established by this Court in *United States* v. *Generes*, *supra*. After the jury returned a verdict in the petitioner's favor, the District Court entered Findings of Fact and Conclusions of Law setting aside a jury's verdict, dismissing the plaintiff's complaint with prejudice and awarding the defendant its costs.[2] On July 27, 1977, the United States

[2] Appendix A.

Court of Appeals for the Sixth Circuit affirmed the district court's judgment in the respondent's favor.[3]

During 1963 and 1964, the petitioner[4] was a corporate officer and shareholder of Hoover, Inc. and Hot Mix, Inc. which was the parent corporation of John L. Burns, Inc. among other companies. All of the corporations were engaged in some phase of the construction business. In order to bid and obtain highway construction jobs, the petitioner's companies obtained performance bonds from Fidelity and Casualty Company of New York.[5]

John L. Burns, Inc., incurred severe financial problems due to a highway construction project in Georgia. In 1963, Fidelity secured a $600,000 line of credit for Burns, Inc. from the Commerce Union Bank of Nashville, Tennessee. Fidelity arranged for Commerce Union Bank to extend an additional $200,000 line of credit to Burns, Inc. in 1964. As a condition of obtaining the line of credit, Fidelity demanded and secured the petitioner's personal guarantee for the repayment of any sums loaned pursuant to the line of credit.[6]

After Burns, Inc. ceased all construction activity in 1965, its assets were sold at a public auction on March 8, 1965. After the auction, Burns, Inc. still owed Commerce Union Bank $594,000. Upon Fidelity's demand that the petitioner honor his personal guarantee of repayment, he transmitted $594,000 to Commerce Union

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[3] Appendix B, p. A-8.

[4] Although Lucinda Hoover is a party to this suit, she is so only by reason of joint returns being filed for the years in issue. All future references will be to the petitioner, Eph H. Hoover, Jr.

[5] Appendix A, Findings of Facts numbered 2-6, pp. A-1 and A-2.

[6] Appendix A, Findings of Facts numbered 7-10, pp. A-2 and A-3.

Bank through Hoover, Inc. and Burns, Inc. Commerce Union Bank was paid on December 29, 1966.[7]

Originally, the payment was deducted by Hoover, Inc. However, the Tax Court in previous litigation found that Hoover, Inc. was a mere conduit for the petitioner and that the bad debt deduction was his. The Tax Court opinion is reported at T.C. Memo 1972-54, ¶ 72,053 P-H Memo T.C. The Court of Appeals for the Sixth Circuit affirmed the Tax Court. Their opinion is officially reported at 474 F.2d 1050 (C.A. 6, 1973), *cert. denied* 414 U.S. 826.

As the district court stated, during 1963 and 1964, the years Mr. Hoover agreed to the guarantee pledges with Fidelity, he received combined salaries of $22,580 and $19,000, respectively, from Hoover, Inc., Hot Mix, Inc., and Burns, Inc.[8] During the same years Hoover, Inc. had accumulated earned surplus of $223,936 and $432,553. The accumulated earned surplus for Hot Mix, Inc. was $50,021 for fiscal year ending July 31, 1963 and $74,382 for fiscal year ending July 31, 1964. For Burns, Inc. its accumulated earned surplus was $76,464 for fiscal year ending January 31, 1963, a deficit of $79,491 for fiscal year ending January 31, 1964, and a surplus of $31,859 for short fiscal year ending November 30, 1964. *Hoover, Inc.*, ¶ 72,054 P-H Memo T.C.

Petitioner owned all of the stock of Hoover, Inc. and was its president during each of the years. As of December, 1964, the petitioner only owned 35% of Hot Mix, Inc. Although by 1966 he had acquired 100% ownership of Hot Mix, Inc. Burns, Inc. was acquired in July of 1964 as a wholly-owned subsidiary of Hot Mix, Inc. *Hoover, Inc., supra*, p. 72-233. Although the Court of Appeals finds it an insignificant fact, Mr.

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[7] Appendix A, Findings of Facts numbered 11 & 12, p. A-3.

[8] Appendix A, Findings of Facts numbered 13, p. A-3.

Hoover devoted his entire working hours to the contracting business.[9]

Part of the evidence introduced in the district court was the petitioner's testimony during the previously mentioned Tax Court case involving Hoover, Inc. The Court of Appeals' opinion relies heavily on the petitioner's testimony that the main reason for advancing the money was to preserve bonding ability.[10] During the district court trial, Mr. Hoover testified that to protect his salary it was necessary for the corporations to maintain their bonding ability.[11]

REASONS FOR GRANTING THE WRIT

The decision below should be reviewed pursuant to Supreme Court Rule 19(1)(b) because the Court of Appeals has decided a federal question in a way in conflict with applicable decisions of this Court. The decision should also be reviewed because it is in conflict with the decision of another court of appeals on the same matter.

BY MISAPPLICATION OF *GENERES*, THE COURT OF APPEALS IMPROPERLY WEIGHED THE CREDIBILITY OF THE PETITIONER AND IGNORED FAVORABLE EVIDENCE WHEN IT AFFIRMED THE DISTRICT COURT'S ORDER GRANTING RESPONDENT'S MOTION FOR JUDGMENT NOT WITHSTANDING THE VERDICT.

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[9] Appendix B, p. A-8.

[10] Appendix B, pp. A-7 and A-8.

[11] Appendix C is two pages of the trial transcript containing petitioner's explanation of his Tax Court testimony. The jury must have believed this testimony in reaching its verdict favorable to the petitioner.

The petitioner testified that his dominant motivation for guaranteeing the liabilities of Burns, Inc. was to protect his position as corporate employee. The jury determined that his dominant motivation was to protect his salary and status as an employee rather than to protect his status as a stockholder. The district court in a complete misapplication of this Court's decision in *United States* v. *Generes*, *supra*, granted respondent's motion for judgment notwithstanding the verdict. The Court of Appeals for the Sixth Circuit affirmed the district court. Thus, not only did it also misapply the *United States* v. *Generes* decision, but its decision also conflicts with the Ninth Circuit Court of Appeals decision in *Anderson* v. *United States*, 555 F.2d 236 (C.A. 9, 1977).

As Judge Van Sickle noticed in *Alsobrook* v. *United States*, 431 F. Supp. 1122, 1128 (E.D. Ark., 1977), the "numerical comparisons contained in *Generes* creates an almost impossible standard for a shareholder-employee to meet in claiming a business bad debt deduction." This is what has happened to the petitioner. Not only did the district court rely solely on the numerical comparisons in granting judgment notwithstanding the verdict, it completely ignored any evidence favorable to the petitioner. For instance, the district court's opinion never cites the fact that the petitioner devoted his entire working hours to the contracting business.

In making its financial comparison, the trial court disregarded this Court's instruction in *Brady* v. *Southern Railroad*, *supra*, pp. 479-480, that the decision be made "without weighing the credibility of the witnesses". The trial court found that the petitioner's testimony was not credible in light of the court's financial analysis.[12]

By its affirmation of the trial court, the Court of Appeals apparently agreed with the district court's weighing of the evidence.

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[12] Appendix A, Conclusion of Law number 4, pp. A-4 and A-5.

In its opinion the Court of Appeals gave special emphasis to the prior Tax Court testimony of the petitioner. This evidence is obviously favorable to the respondent only if the appellate court chose to weigh the evidence and disregard the petitioner's other testimony. Not only did the Court of Appeals weigh credibility and ignore the petitioner's explanation of his testimony in complete contradiction of *Brady* v. *Southern Railroad*, but it dismisses as insignificant the fact that this petitioner devoted full-time to his construction business. Devotion of full-time employment to a corporation was not present in *Generes*. Consequently, not only is the appellate court judging the witness' credibility but it is also weighing the evidence. Thus to affirm the trial court's granting of respondent's motion for judgment notwithstanding the verdict, the Court of Appeals completely disregarded the standard as announced in *Brady* v. *Southern Railroad, supra*, and erroneously substituted its judgment for that of the jury.

This disregard of *Brady* v. *Southern Railroad* standard results from a misapplication of this Court's decision in *United States* v. *Generes*. As previously pointed out one court has found it nearly impossible for a taxpayer to prevail because of the financial analysis this Court adopted when it granted the United States judgment *n.o.v.* in *Generes*. What the Court of Appeals did is misconstrue this Court's reliance in *Generes* on the financial considerations to mean that the taxpayer's testimony is always to be disregarded as self-serving. Moreover, the Court relies exclusively on the financial analysis to the exclusion of any other evidence. Not only does the appellate court ignore the petitioners full-time devotion to the contracting business but it also ignored the complete lack of any evidence that would establish one objective of the transactions was to provide a future source of income for his relatives. The presence of the opposite factor was relied upon by this court in reaching its *Generes* decision.

In addition to ignoring the standards of *Brady* v. *Southern Railroad, supra*, and misapplying the holding of *United States* v. *Generes, supra*, the Court of Appeals holding is directly in conflict with the holding in *Anderson* v. *United States*, 555 F.2d 236 (C.A. 9, 1977). In *Anderson*, the district court found that the plaintiff's dominant motivation in advancing money to his wholly-owned corporation was to protect his status as a corporate employee rather than his status as a shareholder. The Court of Appeals affirmed. The Ninth Circuit held that the trial court's determination of a taxpayer's state of mind is a factual question that in a non-jury trial must be affirmed when the appellate court is convinced that a mistake has not been committed. *Anderson* v. *United States, supra*, p. 237.

On appeal to the Ninth Circuit, the United States attacked the district court's conclusions primarily by the now usual financial analysis of comparing the taxpayer's corporate investment to his current salary. The Ninth Circuit while commenting that this evidence would support a finding that the motivation was to protect the business' value, held that the finder of fact could choose "not to accord especial weight to these items of evidence." *Anderson* v. *United States, supra*, p. 237.

Thus while the Ninth Circuit held in *Anderson*, that a question of intent concerning motivation for advancing money to a corporation is a question of fact, the Sixth Circuit in the present case has held by implication that a *Generes* type of financial analysis which is unfavorable to the taxpayer must always result in judgment for the United States. Of course to reach this conclusion, the Sixth Circuit weighed the petitioner's credibility and ignored facts favorable to the petitioner. This sole reliance on a financial analysis is directly contrary to the Ninth Circuit's determination in *Anderson*, as well as a complete disregard of *Brady* v. *Southern Railroad* and a misapplication of *United States* v. *Generes*.

CONCLUSION

For the reasons previously set forth, the petitioner respectfully requests that a Writ of Certiorari be granted to review the Order of the United States Court of Appeals for the Sixth Circuit and the Order of the United States District Court for the Middle Judicial District of Tennessee.

Respectfully submitted,

H. STENNIS LITTLE, JR.
JOHN B. OWENS, JR.
LITTLE, THRAILKILL AND OWEN, P.C.
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Nashville, Tennessee 37238

Appendices

APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE
NASHVILLE DIVISION

Civil No. 74-437-NA-CV

EPH H. HOOVER, JR. and LUCINDA HOOVER,
Plaintiffs

v.

UNITED STATES OF AMERICA,
Defendant

FINDINGS OF FACT AND CONCLUSIONS OF LAW

In this action, which was tried to the Court and the jury, plaintiffs seek to recover alleged overpayments of income tax for the years 1963 through 1966, inclusive, in the total amount of $259,135.80.

FINDINGS OF FACT

1. This is an action brough by plaintiff [1] for the recovery of $259,135.80 paid as original income tax for the calendar years 1963 through 1966.

2. Plaintiff seeks to deduct [2] for the year 1966 $497,-853.08 as a business bad debt deduction, with an attend-

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[1] Although Lucinda Hoover is a party to this suit, she is so only by reason of joint returns being filed for the years in issue. Accordingly, all future references will be to the single plaintiff, Eph H. Hoover, Jr.

[2] The very same debt that is sought to be deducted by plaintiff herein was originally claimed as a bad debt deduction by plaintiff's wholly owned corporation, Hoover, Inc., which also resulted in litigation. See *Hoover, Inc.* v. *Commissioner*, 31 T.C.M. 221 (1972), affirmed, 474 F.2d 1050 (C.A. 6, 1973). Subsequent to the decision in that case, which was favorable to the Government, plaintiff herein filed timely claims for refund for the years 1963 through 1966, inclusive wherein he asserted that, by reason of the identical transactions, he was entitled to a business bad debt deduction of his personal income tax return.

ant net operating loss carryback deduction to the years 1963, 1964 and 1965.

3. The plaintiff was, during the periods in issue, a controlling shareholder in several corporations, each of which was engaged in some facet or another of the construction business.

4. At all times, plaintiff owned 100% of the stock of Hoover, Inc., the most profitable of the several corporations. Plaintiff was also the principal shareholder of Hot Mix, Inc. and by July of 1966, he had become its sole shareholder.

5. Hot Mix, Inc., in turn, was the parent corporation of John L. Burns, Inc., Burns Equipment, Inc., Concrete, Inc., and Supplies, Inc.

6. During the years in suit, the Fidelity & Casualty Company of New York (hereinafter referred to as Fidelity), as surety, furnished bid and performance bonds necessary for several of plaintiff's companies to bid and perform highway construction jobs.

7. As a result of some problems encountered with a highway construction project in Georgia, one of the aforementioned companies, John L. Burns, Inc. (hereinafter referred to as Burns, Inc.) had, by 1963, suffered serious financial reversals.

8. Consequently, Fidelity arranged for Commerce Union Bank of Nashville, Tennessee, to extend a line of credit to Burns, Inc. that was not to exceed $600,000. That agreement was reduced to writing and executed on October 2, 1963.

9. For a variety of reasons, Fidelity secured an additional line of credit not to exceed $200,000 that was extended by Commerce Union Bank to Burns, Inc. That additional line was executed by an agreement dated June 26, 1964.

10. As part and parcel of obtaining the total $800,000 line of credit, Fidelity demanded that plaintiff not only personally guarantee repayment of any sums advanced thereunder, but also that he assign $1,000,000 to Fidelity as security for that personal guarantee. That assignment was effectuated by a document dated June 29, 1964, whereby plaintiff's liability was not to exceed $800,000.

11. The sums advanced under the $800,000 line of credit were of no apparent help and, by March of 1965, Burns, Inc. had ceased any and all construction activities. In fact, all the operating equipment owned by Burns, Inc. was sold at a public auction on March 8, 1965. The proceeds realized by Burns, Inc., and its other assets, were insufficient to pay back Commerce Union Bank for the monies advanced under the aforesaid line of credit.

12. By December 1, 1966, Burns, Inc. owed the Commerce Union Bank $549,000. Pursuant to plaintiff's personal guarantee of repayment, Fidelity made a demand upon him to remit to Commerce Union the $594,000. By a rather circutious route, the $594,000 was transmitted by plaintiff through two of his corporations, and Commerce Union was paid on December 29, 1966.

13. With respect to those years (i.e., 1963 and 1964) in which the total $800,000 line of credit was secured, plaintiff's gross salaries from all of the aforementioned related corporations were $22,580 and $19,000, respectfully.

14. On the other hand, Hoover, Inc., in which plaintiff owned 100% of the stock, had, for the years 1963 and 1964, cash on hand ranging from $157,766.79 to $236,367.00, accounts receivables ranging from $142,459.99 to $384,738.75, and retained earnings ranging from $223,936.20 to $432,553.57.

15. Additionally, for the fiscal year ended July 31, 1965, Hot Mix, Inc., had cash of $49,683.13, accounts receivables of $772,828.53, and retained earnings of $639,-830.58.

16. Moreover, for the years in issue, plaintiff reported income received by him that was separate and apart from his salaries from his corporations of approximately $131,-109.69 per year.

17. Plaintiff's employment in the salaried positions was not subject to a condition that he indemnify the advances to his corporations. Plaintiff, in substance and effect, controlled the corporations and, as such, controlled his own employment.

18. Plaintiff has not carried his burden of proof that he entered into the agreement to guarantee repayment of the funds advanced by the bank for the principal purpose of protecting his salary, and the evidence fails to support such a finding.

CONCLUSIONS OF LAW

1. The Court has jurisdiction of this action pursuant to Section 1346(a)(1), Title 28, United States Code.

2. Under the record in this case the objective evidence, as opposed to plaintiff's self-serving testimony concerning his subjective intent is determinative with respect to plaintiff's intent in executing the indemnity agreements. *United States* v. *Generes*, 405 U.S. 93 (1972); *Raymond* v. *United States*, 511 F.2d 185 (C.A. 6, 1975).

3. The evidence fails to support the jury's verdict that plaintiff's dominant motive in executing the indemnity agreements was to protect his salary rather than his investments.

4. Plaintiff's self-serving testimony to the effect that, notwithstanding that he had an average "outside" in-

come of $131,109.69 per year, his dominant motive in subjecting himself to a potential liability of $800,000 was to protect a net salary of approximately $13,300 rather than the value of his investments that ranged between $432,553.57 and $1,508,588.71, is not credible and plaintiff's purported explanation of the transaction falls of its own weight. Reasonable minds could not ascribe on the record in this case, a dominant motivation directed to the preservation of plaintiff's salaries. *United States* v. *Generes*, *supra*; *See also Byers* v. *Commissioner*, 472 F.2d 590 (C.A. 6, 1973); *Loventhal* v. *United States*, 478 F.2d 311 (C.A. 6, 1973); *Kelson* v. *United States*, 503 F.2d 1291 (C.A. 10, 1974).

5. The verdict of the jury must therefore be set aside with direction that judgment be entered for the United States.

Pursuant to the foregoing Findings of Fact and Conclusions of law, the verdict heretofore returned by the jury will be set aside and a judgment notwithstanding that verdict will be entered in favor of the defendant, dismissing the plaintiff's complaint with prejudice and awarding the defendant its costs.

Done this ——day of ————————, 1975.

/s/ [Illegible]
United States District Judge

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 76-1197

EPH H. HOOVER, JR. and LUCINDA HOOVER,
Plaintiffs-Appellants

v.

UNITED STATES OF AMERICA,
Defendant-Appellee

ORDER

Before: WEICK, PECK and ENGEL, Circuit Judges

Taxpayers appeal a judgment denying their claim for $259,135.80 in an income refund suit. Although the jury had returned a verdict in the taxpayers' favor, the district court granted a judgment notwithstanding the verdict upon motions of the United States.

The taxpayers contended that certain monies paid by Eph Hoover in 1966 to John L. Burns, Inc., which he indirectly owned, constituted a bad business debt under Section 166 of the ordinary income. The government, on the one hand, took the position that the bad debts were not incurred in the taxpayer's trade or business and should have been treated as a short-term capital loss subject to the restrictions imposed on such losses by Section 166(d)(1)(B).

By a special interrogatory the jury was asked to decide by a preponderance of the evidence whether Mr. Hoover's dominant motivation in signing certain indemnity agreements, which resulted in his ultimate liability,

was to protect his salary and status as an employee rather than to protect his interest as a stockholder. The jury answered affirmatively. The parties and the court agreed that this was the appropriate test under *United States* v. *Generes*, 405 U.S. 93 (1972), to determine if an obligation of a noncorporate taxpayer is a business or non-business debt.

The proofs, viewed most favorably to the plaintiffs, *Fortner Enterprises, Inc.* v. *United States Steel Corp.*, 452 F.2d 1095 (6th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972), demonstrate such an overwhelming disparity between the approximate value of the taxpayer's investment in his interrelated corporations, including John L. Burns, Inc., and his net annual salary therefrom, as to leave no reasonable conclusion other than that his dominant motivation in making the payment was to protect his substantial shareholder investment. Hoover's testimony to the contrary, like that of the taxpayer in *United States* v. *Generes*, *supra*, 405 U.S. at 106, was obviously self-serving and does not survive close analysis. The court notes especially his sworn testimony during a prior case in the United States Tax Court, which was introduced during the trial:

> Q. Why couldn't you have just let John L. Burns go down the drain, so to speak, and set yourself up another sales company if you thought you should have another sales company and do it cheaper than you wound up having to do it and did it?
>
> A. It cost us roughly $600,000 as it did go, and it would have cost roughly that much to set another up, to answer your question. *But the main thing was the fact that we had to preserve our bonding ability.* (Emphasis added)
>
> Q. Bonding for whom?

A. For Hot-Mix and Hoover and our general name in the trade, paying our bills, to be able to get, like we said, to get others to take our prices when we go to a letting or be able to secure bonds from the bonding company.

While it is true that taxpayer Eph Hoover did devote his entire working hours to the contracting business and was therefore more actively involved than the taxpayer in *Generes*, the court finds this distinction was insufficient to call for a different result. Accordingly, the trial court did not err in concluding as a matter of law that "reasonable minds could not ascribe, on the record in this case, a dominant motivation directed to the preservation of 'plaintiff's salaries'." *See Generes*, *supra*, 405 U.S. at 107. Accordingly,

IT IS ORDERED that the judgment of the district court be and it is hereby affirmed.

ENTERED BY ORDER OF THE COURT
John P. Hehman, Clerk

By: /s/ Grace Keller
Deputy Clerk

APPENDIX C

[132] "Answer. We just felt we had to. We incurred the debts and we had to pay them."

That's about as direct as you can get, isn't it?

BY THE COURT: Don't argue with the witness. Ask him if he said it.

Did you say it?

A. Yes, sir.

BY THE COURT: All right, he said it.

BY MR LUTZ: (Continuing)

Q. Mr. Hoover, now, you testified, according to the certified copy of your Tax Court testimony, you testified that the reason you signed these indemnity agreements was to protect the bonding ability, financial integrity of these companies in addition to your personal distaste for bankruptcy.

BY THE COURT: Is that what you testified?

A. No, sir, I don't know. If you will show me where I testified.

BY MR. LUTZ: (Continuing)

Q. Mr. Hoover, do you know whether or not you testified here today to the effect that the reason you signed the indemnity agreements was to protect your salary, your status as an employee?

A. Yes, sir.

Q. What is true, Mr. Hoover, did you sign it to [133] protect the financial integrity and bonding ability of the corporations or did you sign it to protect your salary, now, which is it?

A. To protect my salary; all the other had to happen.

Q. Pardon?

A. I said to protect my salary the companies had to stay in business, to pay me a salary, and all of it—I don't see where there's any contradiction anywhere. It's all in continuity, as far as I am concerned.

Q. Is it your testimony that you signed the indemnity agreements to keep your corporations in business, otherwise they would be out of business, they would be bankrupt and naturally you would lose your job?

A. So they could go on and pay me my salary that I was getting from them, that's my testimony.

BY MR. LUTZ: Your Honor, may I approach the Bench?

BY THE COURT: Yes.

(Thereupon counsel approached the bench for a discussion out of hearing of the jury)

BY MR. LITTLE: Your Honor, let me say one thing, I guess we have got to allow this continuing testimony, and I suppose he has a right on cross-examination.

BY MR. LUTZ: I am finished with that.

BY MR. LITTLE: But there is no inconsistency in my opinion on this.

Supreme Court, U. S.
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EPH H. HOOVER, JR. AND LUCINDA HOOVER, PETITIONERS

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UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

DANIEL M. FRIEDMAN,
Acting Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-597

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UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question presented by the petition in this federal income tax case is whether the courts below correctly held that certain payments by petitioner Eph Hoover[1] to a corporation of which he was the principal shareholder were not deductible as business bad debts and therefore resulted in capital rather than ordinary losses.

Petitioner was a principal shareholder in a group of related corporations engaged in the road construction business. He also was an officer of each of the corporations and drew from them an annual total salary

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[1]The term "petitioner" refers to Eph Hoover. Lucinda Hoover is a party only because she filed joint income tax returns with her husband for the years involved.

of approximately $20,000. Petitioner had additional income of approximately $131,000 per year. In 1963 and 1964, petitioner personally guaranteed loans of approximately $800,000 to one of the corporations. In 1966, the borrowing corporation defaulted on the loans and petitioner paid approximately $594,000 on his guaranties (Pet. App. A-3, A-4).

On audit, the Commissioner of Internal Revenue disallowed petitioner's claimed business bad debt deduction for the payment on his guaranties. The Commissioner determined that the payment was a nonbusiness bad debt that resulted in a capital loss under Section 166(d) of the Internal Revenue Code of 1954, as amended (26 U.S.C.). In this refund suit brought by petitioners in the United States District Court for the Middle District of Tennessee, petitioner testified that his dominant motive was to protect his salaried position so that the loss resulting from the payment of his guaranty was from a business bad debt under *United States* v. *Generes*, 405 U.S. 93. Although the jury found in favor of petitioner, the district court set aside its verdict on the ground that it was "not credible" that petitioner's dominant motive was to protect a salary that was small when compared to his other income, his investment in the corporations, and his personal liability as a guarantor (Pet. App. A-1 to A-5).

The court of appeals affirmed by order (Pet. App. A-6 to A-8). It held that the "overwhelming disparity" between petitioner's investment in the corporations and his salary permitted "no reasonable conclusion other than that his dominant motivation in making the payment was to protect his substantial shareholder investment" (Pet. App. A-7).

The decision below is in accord with *United States* v. *Generes*, *supra*. There, as here, a jury accepted the

taxpayer's testimony that he was motivated by a desire to protect his job. However, this Court held that the objective economic evidence would not support the conclusion that the taxpayer's dominant motive in making the guarantee was to protect his salaried position with the corporation.[2]

Petitioner contends (Pet. 7) that the district court misapplied the *Generes* rule by relying "solely on the numerical comparisons" and that it "completely ignored any evidence favorable to the petitioner." But the numerical comparison—*i.e.*, the disparity between the taxpayer's financial stake in his investment as compared to his salaried position—is precisely what the Court in *Generes* held to be dispositive. While petitioner emphasizes that he devoted himself full-time to his contracting business, the court of appeals properly held that this was not a basis upon which to distinguish *Generes*.[3]

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

DANIEL M. FRIEDMAN,
Acting Solicitor General. *

DECEMBER 1977.

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[2]Indeed, the government's position in this case is even stronger than *Generes*. There, the after-tax ratio of investment to salary was about 5 to 1 (405 U.S. at 107). Here, the ratio ranged from 20 to 1 to 75 to 1 (Pet. App. A-5).

[3]*Anderson* v. *United States*, 555 F. 2d 236 (C.A. 9), upon which petitioner relies (Pet. 7, 9), is not to the contrary. There, the court affirmed a finding that the dominant motive of a taxpayer-lender was to protect his job rather than his investment in the corporate borrower. Here, however, both courts below ruled that the objective economic evidence could not support such a finding.

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*The Solicitor General is disqualified in this case.

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v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONERS' REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Pursuant to rule number 24(4) of the *Rules of the Supreme Court of the United States,* Petitioners hereby file this reply to the United States of America's Memorandum in Opposition to the Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit. In its memorandum in opposition, the Respondent is making the exact misapplication of *United States* v. *Generes,* 405 U.S. 93 (1972) that the Petitioners contend the lower Courts have made. Respondent, while making this misapplication of *Generes,* ignores other evidence that was available to the jury when it decided that

the Petitioner was entitled to a verdict. On page three (3) of its brief, the Respondent states:

> . . . the numerical comparison . . . is precisely what the Court in *Generes* held to be dispositive . . .

Thus it is readily apparent that the United States misapplies *Generes* as the lower courts did and holds that the numerical comparison is dispositive despite not only the existence of controverted financial evidence, but is also dispositive despite other evidence showing the taxpayer's dominant motivation.

The Petitioner contends that the financial analysis is not unfavorable to the taxpayer as the government contends in footnote two on page three of its memorandum in opposition. The government is assuming incorrectly that the Petitioners agree with the District Court's financial analysis. This is not correct. This is the precise reason why the Petitioners contend that the lower courts have ignored this Court's instructions as set forth in *Brady* v. *Southern Railroad,* 320 U.S. 476 (1943). While the District Court relies on the unrealized value of the taxpayer's investment in 1965 and 1966, the taxpayer contends that his original investment in all three companies was only $11,350. His salaries from the three companies were $19,000 in 1963 and $22,580 in 1964. Thus, it should be abundantly clear that the jury could have found, as it evidently did, that the guarantee was being made to protect the taxpayer's salary, not his original investment. Moreover, it would be inconceivable that a rational man would consider protecting an investment of $11,350 by personally signing guarantees for $800,000. Guarantees which he eventually had to make good in the amount of $549,000.

Not only is the government's memorandum ignoring the fact that the financial analysis was hotly disputed, but it also ignores the fact that also the original indemnification agreement was signed on October 2, 1963 and the second one was signed in July of 1964 for an additional $200,000

for a total of $800,000 of personal guarantees. The District Court considered the unrealized value of the Petitioner's investment during subsequent years to determine the taxpayer's dominant motivation on the dates the agreements were executed. Even if the District Court and the government were correct in considering the unrealized value of the Petitioner's investment, the proper date is the date the agreements were signed. The only evidence of Hoover, Inc.'s value would be its earned surplus of $223,936.20 for 1963 and $432,553.57 for 1964.* Hot-Mix, Inc. and its related companies which included John L. Burns had a negative earned surplus of $76,098.18 in 1964. Therefore, even if the Petitioner's unrealized gain, as reflected by the earned surplus, is a proper measure of value, it was certainly reasonable for the jury to determine that the taxpayer's dominant motive in signing the $800,000 guarantee was to protect his present and future salary. It is obvious that the jury could have reasonably believed that the taxpayer would not risk $800,000 to protect an investment that had an unrealized value of approximately $220,000 to $360,000 based solely on earned surplus.

The Jury could have reasonably found from the evidence, as its verdict indicates, that the Petitioner's dominant motivation in guaranteeing the loans was to retain and enhance his salary. One evidentiary basis for the jury decision's could be the Petitioner's evidence that

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*Of course, a corporation's earned surplus does not necessarily represent its fair market value. The earned surplus is merely the total earnings and profits retained and reinvested in the business. Most of the earned surplus could be represented by depreciated machinery and working capital necessary to finance the next construction job. In fact, due to the accounting profession's use of historical cost on balance sheets, it is highly unlikely that a corporation's earned surplus would represent its net liquidation value.

there are very few sales of construction companies. Thus, in addition to the other favorable evidence, there is more than sufficient evidence in the record to support the jury conclusion that the Petitioner was protecting and enhancing his employment rather than his equity investment in a corporation which he has very little chance of selling.

It was the jury's decision to determine the Petitioner's dominant motivation based on the financial information it believed was significant. By its verdict, it is obvious that the jury decided that the Petitioner's dominant motivation in advancing the $800,000 was to protect his salary and not a lesser investment. It was the jury's duty to determine the Petitioner's dominant motivation based on the evidence and not the Trial Court's duty to second guess the jury by granting a motion for judgment n.o.v., when the evidence is clearly conflicting. *Brady* v. *Southern Railroad, supra.*

The United States is also incorrect when it states that the District and Circuit Courts rules in *Anderson* v. *United States,* 555 F.2d 236 (C.A.9, 1977), that the objective economic evidence could not support a finding that the dominant motivation of a taxpayer was to protect his corporate investment rather than his employment. As noted in the Ninth Circuit opinion, the government relied on the objective economic evidence heavily to support its contention that the taxpayer's dominant motive was to protect his investment rather than his job. However, as a Ninth Circuit pointed out in *Anderson,* that evidence, the objective economic evidence, is not the only basis upon which the taxpayer's dominant motive could be determined. However, in its Memorandum in Opposition, the Respondent is now contending that the numerical comparison was held to be dispositive by this Court in *Generes.* If that is true, then the Court of Appeals for the Ninth Circuit is misapplying *Generes* and there is a conflict between it and the Sixth Circuit's opinion in this case. So, not only is the United States misconstruing

Generes and *Anderson,* but is ignoring this Court's dictates in *Brady* v. *Southern Railroad,* to determine the taxpayer's motivation in advancing money to John L. Burns, Inc.

Not only is the United States and the District Court relying on conflicting economic evidence, it is ignoring all the other objective factors which indicate that the Petitioner signed the guarantee for the dominant motivation of protecting his salary not his investment. The lower courts have ignored completely the evidence that the appellant had only one job, a job working for a corporation created to provide him with salaried employment. As opposed to the situation in *Generes,* the appellant did not create these corporations to provide his relatives with jobs. The evidence at trial established that the appellant worked long and hard hours for the corporation. He was not a passive officer and investor as was the situation in *Generes.* The present case is factually distinguishable by *Generes* in every manner. Moreover, contrary to the District Court's finding that the taxpayer has average income of $131,009.69 per year, his income tax returns for 1963 and 1964 showed additional income of $25,365.48 for 1963 and $38,439.05 for 1964. Moreover, it should be recognized that this additional income was from rent, royalties and pensions, etc. and did not constitute income from active employment. They were a passive source of income.

Thus, not only did the lower courts ignore the fact that the so-called objective economic evidence was in dispute as to the proper year and amounts, but they ignored other credible evidence that could have supported the jury's verdict in the taxpayer's favor. After the jury returned its favorable verdict for the taxpayer, the District Court weighted the evidence and decided that a different result was required. Thus, ignoring *Brady* v. *Southern Railroad,* the District Court took the jury verdict away from the

taxpayer by weighing the evidence and determining the facts contrary to the jury. Upon appeal, the Sixth Circuit Court of Appeals affirmed the District Court. Thus, it completely disregarded the dictates of *Brady* v. *Southern Railroad, supra.*

CONCLUSION

For the reasons stated, it is respectfully requested that the petition for a Writ of Certiorari should be granted.

Respectfully submitted,
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